ENERGY SECTOR SPOTLIGHT ■ NOVEMBER 2019

PATIENTLY POSITIONED FOR A TURNAROUND

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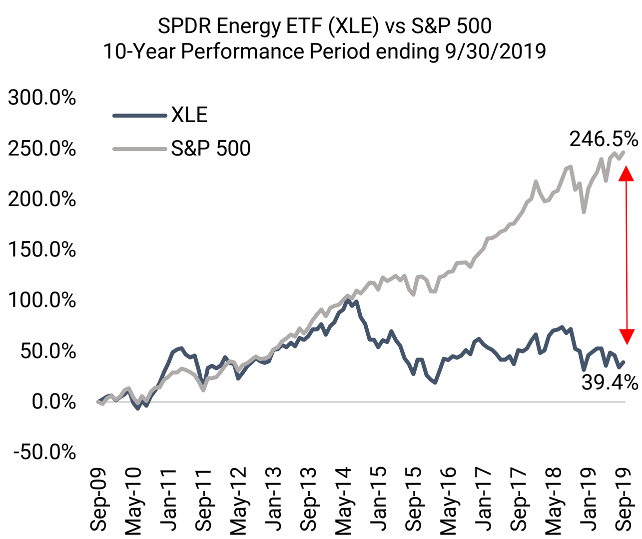
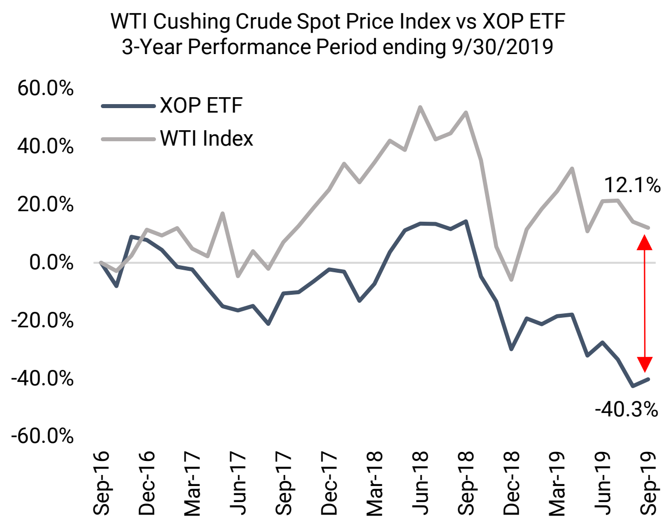
The phrase "patience is a virtue" dates as far back as the 14th century, where it appears in a William Langland poem titled *Piers Plowman*. The centuries-old expression continues to resonate with us at Hotchkis & Wiley where we recognize that market trends change but often take a long time to do so. Market sentiment can be a powerful force. For example, news headlines often trigger a negative feedback loop that causes investors to panic, rather than exercise thoughtfulness and restraint, i.e. patience. Nowhere has this phenomenon been more prevalent over the past few years than in the energy sector. In fact, energy sector underperformance relative to the broad market is at a multi-year low.

Chart 1: Energy Sector Performance Lagging the Broader Market



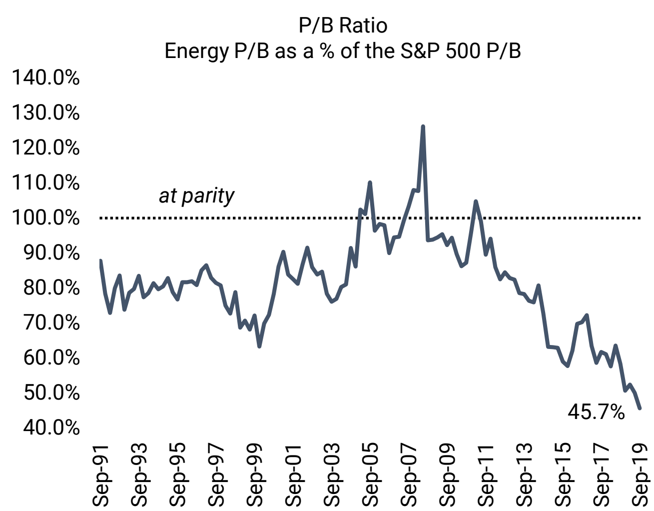
Much of this underperformance is a result of trade tensions between the world's two largest economies, which has led to souring market sentiment on US oil and gas producers. What is surprising to us is the disconnect between relatively stable oil prices and E&P names as measured by the SPDR S&P Oil & Gas Exploration & Production ETF (XOP). WTI Crude is at the same level it was at the end of 2016 but XOP has traded down more than 40% over the same period. This is the widest performance spread between WTI and XOP in recent history.

Chart 2: WTI vs XOP – Relative Returns



Unsurprisingly, energy valuations are now at a historic discount to the broad market as shown below.

Chart 3: Energy Valuations at Historically Attractive Levels

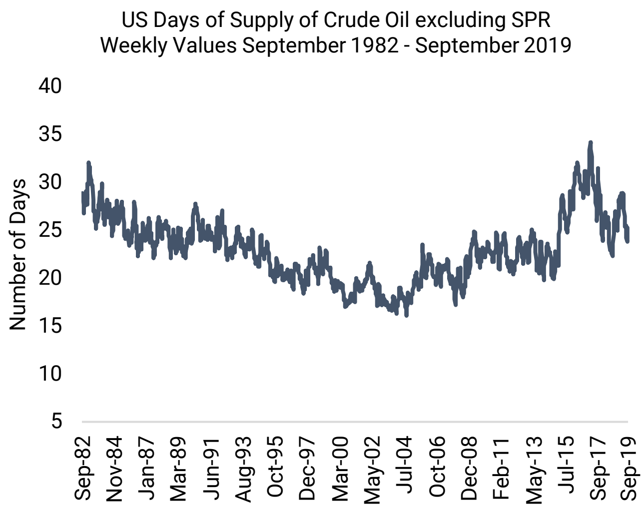


So why have energy securities become so undervalued? **We believe there are three key myths that the market is failing to adequately understand**.

Myth #1: The market is oversupplied.

Current investor perception seems to be that the world is awash in crude, thanks largely to new technologies and efficiencies gained in US oil and gas drilling. Despite US days of supply peaking in 2017, current values are roughly the same as 30 years ago.[1]

Chart 4: US Oil Supply Trending Lower in 2019



Globally, OECD commercial oil stocks are running 1.2 days below the latest five-year average.[2] OPEC has been quite disciplined recently which has helped keep a lid on crude oil stocks, and therefore providing some stability to physical crude prices. However, risks to global supply chains that could result in oil price shocks should not be overlooked.

Consider the impact of geopolitical flareups like the one that occurred September 14th when a major oil processing plant in Saudi Arabia was hit by several drones, temporarily eliminating about 5% of global oil output overnight. **We have repeatedly stated and continue to believe there is more fragility to the global oil supply chain than the market is pricing in**. Although it appears Saudi crude production has been restored to near pre-strike levels, it highlights fragile nature of the global oil supply. Many large oil producing countries (e.g. the Middle East) are politically unstable and frequently embroiled in conflicts that could lead to additional oil infrastructure disruption. We also believe it is highly unlikely that Iranian oil, for example, will be released on the world market anytime soon. Further, lumpy capacity from other areas like Norway, Brazil and Guyana have a limited impact on global crude supply.

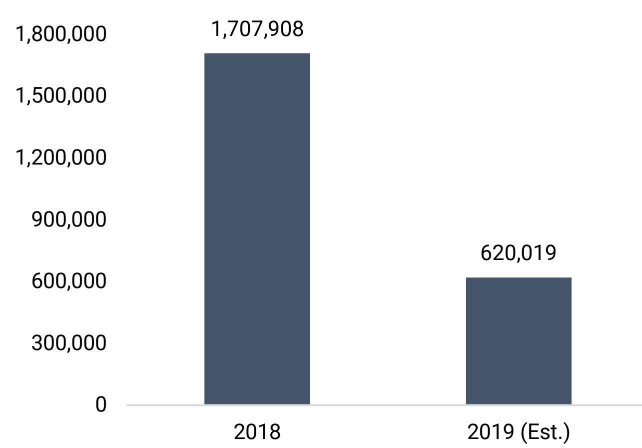
One may argue that the US could backfill any loss in production overseas, which brings us to the next myth.

Myth #2: US oil & gas production is growing rapidly.

We believe US production is the most misunderstood part of the energy market, contributing to today's extreme dislocations. Yes, US production has ramped up meaningfully over the past ten years due to technological innovations in extracting shale oil. However, the market doesn't appear to take into consideration that decline rates in the US are the highest in the world. As an oil well ages, it produces less oil—the most easily accessible oil is extracted first, so it becomes increasingly difficult and costly to extract remaining oil in subsequent years. This slowing pace is referred to as a well's decline rate. Production growth, therefore, equals prior production, *less* natural declines, *plus* production from new wells. Due to the complexities of hydraulic fracturing, high decline rates in the US are underappreciated when it comes to projecting future production. It takes increasing amounts of exploration and production activity to maintain stable growth levels. Our research tells us that if the number of wells remains constant, production growth would fall by half.

As of the end of September we observe *production growth* in 2019 running well below half the level of 2018.

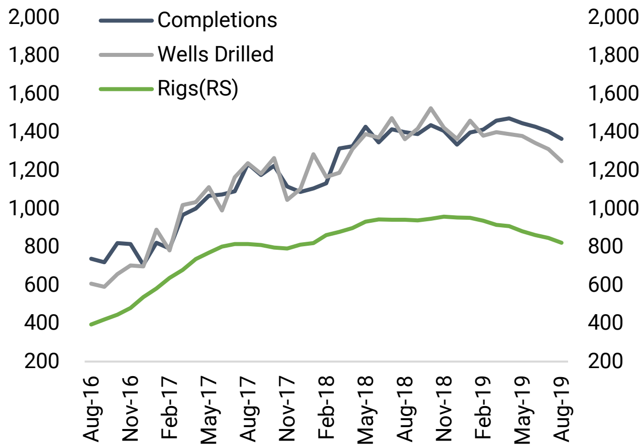
Chart 5: US Y-o-Y Production Growth (bbls/day)



[1] U.S. Energy Information Administration
[2] OPEC Monthly Oil Market Report – October 2019

Additionally, E&P companies have indicated they are reducing activity (i.e. cutting capital expenditures), not increasing activity. This is reflected in Chart 6 which tells us oil rig counts are falling, as are drilled wells which will eventually lead to a further decline in completions.

Chart 6: Trends in Rigs, Wells Drilled and Completions

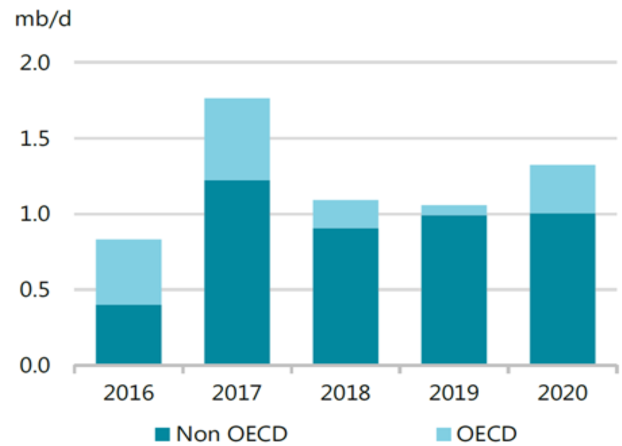


Without a considerable increase in oil prices US production growth is likely to be minimal versus current expectations of 1.2 mm bbls a day of growth. Based on our research, monthly production adds would have to be about 20% higher to meet production expectations. That isn't happening.

Myth #3: Demand for oil is falling.

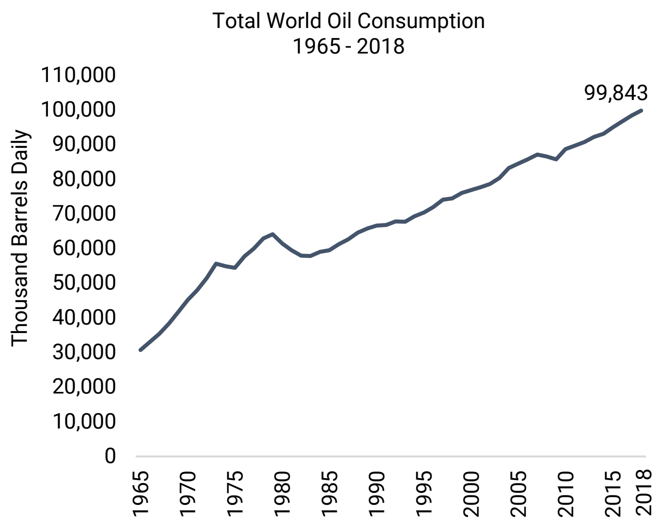
2019 has been fraught with concerns of slowing growth, thanks largely to uncertainty around global trade and Brexit uncertainty. There are knock-on effects that have not only impacted growth in recent quarters for many of the world's largest economies but are also limiting visibility into future economic growth projections. Despite these issues, oil demand continues to grow sequentially year-over-year thanks in large part to heightened demand from non-OECD (Emerging) countries.

Chart 7: Recent Global Oil Demand Growth, Y-o-Y[3]



It is worth noting that apart from a few recessionary periods world oil consumption has been trending upward over the past fifty years. Incidentally, we do not anticipate another recession to be around the corner as some market pundits would suggest.

Chart 8: Historical World Consumption Growth[4]



Considering the reduced production activity we are seeing in the US and discipline being exercised by OPEC, any uptick in demand could lead to an unexpected shortfall, driving oil prices considerably higher.

[3] IEA Oil Market Report – September 12, 2019

[4] BP Statistical Review of World Energy – June 2019

Regardless, the underperformance of energy securities in recent years has created an uncommon investment opportunity set as good as we've seen in the past 30 years. Our robust internal research engine looks beyond the short-term noise to find good businesses that are generating strong free cash flow and trade at substantial discounts to intrinsic value. It just so happens that many US E&P names meet the investment criteria we look for. Negative sentiment has driven the energy sector to a multi-decade low weighting in the S&P 500 Index but this is an industry providing essential products and services to society and is therefore without obsolescence risk.

As is the case with any industry, there will be winners and there will be losers. As painful as the energy exposure has been this year, we see signs of headwinds turning into tailwinds. Our research is informed by our experience which at times requires a significant amount of patience – patience that we believe will ultimately reward our shareholders.

Data source: Charts 1&2: Bloomberg, H&W; Chart 3: Bloomberg, S&P, H&W; Chart 4: EIA, H&W; Charts 5&6: IEA, H&W; Chart 7: IEA; Chart 8: BP, H&W